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SFC reprimands and fines Sun On Tat Securities Company Limited and its responsible officer \$1.8 million

5 Sep 2013

The Securities and Futures Commission (SFC) has reprimanded Sun On Tat Securities Company Limited (Sun On Tat) and fined it \$1,600,000 for internal control failings in a number of aspects of its operations (Note 1).

The SFC has also reprimanded Ms Kwong Suk Yee, a responsible officer of Sun On Tat, and fined her \$200,000 for managerial and supervisory failures (Note 2).

An SFC investigation into Sun On Tat's internal controls was commenced following an inspection at Sun On Tat in 2010, which identified a number of internal control deficiencies, some of which were similar to internal control deficiencies identified during an earlier inspection at Sun On Tat in 2006.

The SFC's investigation revealed that:

- Sun On Tat used one client's securities to settle another client's transactions;
- Sun On Tat failed to promptly and properly deposit client securities that it received in appropriate segregated accounts;
- there was inadequate segregation of front office and back office duties at Sun On Tat;
- Sun On Tat failed to promptly provide daily statements of accounts and contract notes to clients;
- Sun On Tat did not impose restrictions on access to trading documents; and
- management supervision of Sun On Tat's business activities was not adequate.

Sun On Tat's internal control failings are serious. Inadequate management supervision, coupled with deficiencies in other areas of internal controls, makes Sun On Tat's operations susceptible to abuse and malpractice to the prejudice of the firm's and clients' interests without the transgressions being noticed by management. Particularly, Sun On Tat's practice of allowing securities belonging to one client to be used for settling transactions of another client is directly contrary to the fundamental obligation of licensed corporations to keep client assets in safe custody. Such practice cannot be tolerated even if clients are made whole again.

The SFC found that Sun On Tat's failures are attributable to the neglect of Sun On Tat's senior management members and responsible officers. In particular, Kwong was responsible for overseeing all of Sun On Tat's front and back office operations and its compliance function (Note 3).

In deciding the sanctions, the SFC took into account all the circumstances including:

- Sun On Tat had failed to take steps to rectify some of the internal control deficiencies identified during the SFC's 2006 inspection until similar deficiencies surfaced again at the SFC's 2010 inspection;
- Sun On Tat has, since the SFC's 2010 inspection, engaged an independent accountant to review its internal controls, and the result of the review suggests that Sun On Tat has largely remedied its internal control deficiencies;
- some of the malpractices that existed at Sun On Tat are very serious and jeopardised its clients' interests;
- Kwong's inadequate management and supervision engendered a weak compliance culture at Sun On Tat, as exemplified by the fact that some of its internal control deficiencies had lasted at least four years;
- Sun On Tat and Kwong co-operated with the SFC in its investigation; and
- Sun On Tat has no disciplinary history with the SFC.

End

Notes:

1. Sun On Tat is licensed under the Securities and Futures Ordinance (SFO) to carry on Type 1 (dealing in securities) regulated activity.
2. Kwong is licensed under the SFO to carry on Type 1 (dealing in securities) regulated activity. Kwong is a responsible officer of Sun On Tat.
3. Kwong was a member of Sun On Tat's senior management and one of its three responsible officers at the material time. In August 2010, one of the responsible officers left Sun On Tat. In May 2011, another responsible officer passed away.

4. A copy of the [Statement of Disciplinary Action](#) in relation to the matter is available on the SFC website.

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STATEMENT OF DISCIPLINARY ACTION

1. The Disciplinary Action

- 1.1. The Securities and Futures Commission (**SFC**) has taken the following disciplinary action against Sun On Tat Securities Company Limited (**Sun On Tat**) and Kwong Suk Yee (**Kwong**) pursuant to section 194 of the Securities and Futures Ordinance (**SFO**):
 - 1.1.1. publicly reprimanded Sun On Tat and Kwong, pursuant to section 194(1)(b)(iii) of the SFO; and
 - 1.1.2. imposed a financial penalty of \$1.6 million and \$200,000 on Sun On Tat and Kwong respectively, pursuant to section 194(2)(b) of the SFO.
- 1.2. The disciplinary action relates to internal control deficiencies in Sun On Tat's operations and inadequate management supervision exercised by Kwong in her capacity as a responsible officer of Sun On Tat.

2. Summary of facts

- 2.1. In 2010, the SFC's Intermediaries Supervision Division (**ISD**) conducted a limited review of Sun On Tat's operation (the **2010 Inspection**) which identified a number of internal control deficiencies. Some of the deficiencies identified were similar to internal deficiencies that were identified during an earlier limited review by the ISD in 2006 (the **2006 Inspection**). Following the 2010 Inspection, Sun On Tat agreed to engage an independent external accountant (**Reviewer**) to conduct a review of its internal control systems and procedures, and to make recommendations for any necessary improvement and/or rectification (the **Internal Control Review**).
- 2.2. Separately from the Internal Control Review, the SFC conducted an investigation into Sun On Tat's internal control systems and procedures as they existed before the 2010 Inspection and as they exist after the 2010 Inspection.
- 2.3. Our investigation findings suggest that a number of internal control deficiencies had existed at Sun On Tat up until the 2010 Inspection, and the existence of such deficiencies also reflects the inadequacies in the management supervision of Sun On Tat's business activities.

Using one client's securities to settle another client's transaction

- 2.4. Sun On Tat is a participant of the Central Clearing and Settlement System (**CCASS**). All client securities of Sun On Tat are held with

CCASS. Sun On Tat has four stock accounts with CCASS that are used for different purposes, including:

- the Clearing Account (A/C 01) which is used primarily to settle transactions in CCASS;
- the Entitlement Account (A/C 02) which is used by the Hong Kong Securities Clearing Company Limited for distributing benefit entitlements to CCASS participants and for effecting adjustments in benefit entitlements; and
- the Cash Clients Account (A/C 04) for holding Sun On Tat's cash clients' securities.

- 2.5. During the course of our investigation, we found three instances in 2009 and 2010 where Sun On Tat had transferred shares belonging to one client in the Entitlement Account (A/C 02) or the Cash Clients Account (A/C 04) to the Clearing Account (A/C 01) to settle the sale of shares that another client had short sold. Shares in the quantity short sold were subsequently bought from the market, presumably to replace the shares that Sun On Tat had used to settle the short sales.
- 2.6. Sun On Tat told us that whenever there was short selling by Sun On Tat's clients, it was Sun On Tat's usual practice to use other clients' securities from the Cash Clients Account (A/C 04) to settle the transaction, unless other clients did not have the relevant securities in hand for settlement purposes. It was believed that the practice had lasted around 10 years.
- 2.7. Although there is no evidence Sun On Tat's clients have suffered any loss as a result of Sun On Tat's practice of using one client's securities to settle another client's transactions, such practice clearly and fundamentally jeopardizes its clients' interests. Such practice also breaches section 6(1) of the Securities and Futures (Client Securities) Rules (**CSR**), which requires an intermediary to obtain a written direction to withdraw the client securities which it holds in a segregated account before withdrawing such securities.

Failure to promptly and properly segregate client securities

- 2.8. Section 5 of the CSR requires, amongst other things, that any intermediary which receives any client securities shall ensure that, as soon as reasonably practicable¹, the client securities are deposited in safe custody in a segregated account which is designated as a trust account or client account maintained in Hong Kong by the intermediary for the purpose of holding client securities or registered in the name of the client on whose behalf the securities have been received.
- 2.9. Our investigation revealed that Sun On Tat did not promptly and properly transfer securities from its CCASS Clearing Account (A/C 01) to designated segregated accounts on 7 occasions in 2010. The

¹ According to Question 11 of the Frequently Asked Questions on the CSR posted on 17 March 2003, "as soon as reasonably practicable" generally means "within 1 business day" for the transfer of securities amongst the CCASS accounts.

securities were only transferred to the appropriate segregated accounts after a period ranging from 3 to 25 days after Sun On Tat's receipt of the client securities.

- 2.10. According to Sun On Tat and Kwong, the delay was caused by a failure in CCASS' system in depositing client securities into appropriate segregated accounts. Kwong accepted that it was negligent of Sun On Tat to have failed to detect the system failure.

Inadequate segregation of front office and back office duties

- 2.11. ISD found during the 2006 Inspection that there was inadequate segregation of front office and back office duties at Sun On Tat - account executives who handled client orders were also found to be performing certain back office functions. Similar infractions were found during the 2010 Inspection.

- 2.12. During the course of our investigation, Sun On Tat's account executives and Kwong confirmed that Sun On Tat's account executives had been handling client orders as well as performing back office functions up until the 2010 Inspection. Indeed, Kwong also admitted that she had been overseeing Sun On Tat's internal control system as well as handling client orders.

- 2.13. Part II of the Management, Supervision and Internal Control Guidelines for Persons Licensed By or Registered with the Securities and Futures Commission (**Internal Control Guidelines**) provides that "*Key duties and functions shall be appropriately segregated, particularly those duties and functions which when performed by the same individual may result in undetected errors or may be susceptible to abuses which may expose the firm or its clients to inappropriate risks.*" The evidence suggests that Sun On Tat has failed to comply with this provision for at least four years, i.e. between the 2006 Inspection and the 2010 Inspection.

Failure to provide trading documents promptly

- 2.14. Section 5 of the Securities and Futures (Contract Notes, Statement of Accounts and Receipts) Rules (**Contract Notes Rules**) requires, amongst other things, that an intermediary which enters into a contract for a dealing in securities with or on behalf of a client to prepare a contract note and provide the same to the client no later than the end of the second business day after entering into the contract.

- 2.15. Section 8 of the Contract Notes Rules requires an intermediary which provides financial accommodation to a client to prepare and provide to the client a statement relating to the account of the client on the day certain event take place (for example, where there is an adjustment of the amount of financial accommodation or any movement affecting the account balance).

- 2.16. Section 9 of the Contract Notes Rules requires an intermediary which enters into a margined transaction with a client to prepare and provide

to the client a statement relating to the account of the client on the day the transaction is entered into or closed.

2.17. In both 2006 Inspection and 2010 Inspection, ISD found that, in breach of the above-mentioned sections of the Contract Notes Rules, Sun On Tat failed to promptly provide daily statements of account and contract notes to clients. The said trading documents were only provided to clients when the clients had settled the outstanding balances with Sun On Tat. Kwong and Sun On Tat's account executives confirmed, during the course of our investigation, that this was the case up until the 2010 Inspection.

Failure to have adequate control over access to trading documents

2.18. ISD found during the 2010 Inspection that trading documents and blank copies of statements were placed in open areas at Sun On Tat's offices without restricted access. Kwong and Sun On Tat's account executives confirmed, during the course of our investigation, that this was the case up until the 2010 Inspection.

Inadequate management and supervision

2.19. In the 2006 Inspection, ISD found a number of breaches and deficiencies in Sun On Tat's business operation and was of the view that the management of Sun On Tat had not established nor implemented adequate internal controls over key operational functions. ISD considered that Sun On Tat's management and supervisory functions might not have been effectively and adequately performed to guard against abuses and malpractice by staff and to minimize the potential for conflicts, errors or abuses, thus exposing Sun On Tat or its clients to inappropriate risks.

2.20. In the 2010 Inspection, ISD, again, found that the management supervision of Sun On Tat's business activities might not have been adequate for ensuring compliance with all applicable rules and regulations. In particular, it was noted that there was no independent management review on a number of key operational procedures such as stock reconciliation, bank reconciliation and reconciliation of the trust bank account balance against client payable.

2.21. The insufficient management supervision over Sun On Tat's operations before the 2010 Inspection is also borne out in the evidence we obtained from Kwong and Sun On Tat's account executives during our investigation:

No action taken to rectify Sun On Tat's system failures

2.21.1. With respect to the instances where we have found Sun On Tat using clients' securities to settle short-selling transactions belonging to other clients, a Sun On Tat account executive told us that the practice of using clients' securities to settle other clients' short-selling transactions had lasted around 10 years. Further, Sun On Tat's failure to transfer securities that it had received to appropriate segregated accounts was also caused by a system failure. It appears that Sun On Tat's management was either not aware of those system failures, or

they took no action to rectify them until after the 2010 Inspection.

No independent review on a number of key operational procedures

2.21.2. With respect to Sun On Tat's failure to promptly and properly segregate client securities, a Sun On Tat account executive told us that no one in Sun On Tat reviewed the relevant reports to ensure that securities were properly deposited into appropriate segregated accounts.

2.21.3. Sun On Tat did not have clear guidelines as to where / with whom responsibility lied with respect to certain key functions like settlement, stock reconciliation and stock segregation - the evidence given by Kwong and one of Sun On Tat's account executives suggest that there was some confusion as to what each staff's duties were.

Sun On Tat's failures

2.22. Our investigation findings revealed that Sun On Tat has had a variety of internal control deficiencies since at least 2006. Despite having been alerted to shortcomings in its internal controls through the 2006 Inspection, Sun On Tat's management failed to take effective remedial measures to ensure that appropriate control and supervisory procedures which can be reasonably expected to protect Sun On Tat's operation and client's interests are implemented.

2.23. The fact that Sun On Tat did not act, or did not act sufficiently, to implement and maintain a proper internal control system notwithstanding the reminder that was given to it after the 2006 Inspection suggest that Sun On Tat either did not understand the importance of implementing and maintaining such system, or it did not take our advice seriously. It appears that only when we expressed our concerns about Sun On Tat's internal controls again, coupled with some forewarning that regulatory actions could follow depending on Sun On Tat's ability to take prompt and effective rectifying measures to address all our concerns, was Sun On Tat motivated to comprehensively address all shortcomings in Sun On Tat's internal controls.

Kwong's failures

2.24. We are of the view that Sun On Tat's internal control failings are attributable to the neglect on Kwong's part, in her capacity as a responsible officer of Sun On Tat, of her supervisory and managerial duties. Our view is based on the following:

2.24.1. Kwong is the responsible officer at Sun On Tat who has the responsibility to oversee compliance and all front/back office operations at Sun On Tat. In such capacity, pursuant to General Principle 9 of the Code of Conduct, she bears primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the firm, so that the firm conducts its business activities in

compliance with the laws, rules and regulations and codes administered or issued by the SFC. We find that Kwong has failed to fulfil such responsibility because she has failed to implement proper procedures and control that can be reasonably expected to protect Sun On Tat's operation and clients' interests throughout the years;

2.24.2. Kwong was aware of the inadequate segregation of front office and back office duties at Sun On Tat as a result of the 2006 Inspection but did not cause adequate measures to be put in place to rectify the position until after the 2010 Inspection;

2.24.3. safe custody of clients' assets is one of the most fundamental obligations of licensed corporations; the fact that the practice of using one client's securities to settle another client's transactions had lasted around 10 years either without Kwong noticing it or with Kwong's connivance suggests that she has acted negligently in discharging her duty in overseeing Sun On Tat's operations; and

2.24.4. although Kwong was aware that (i) daily statements and contract notes were treated as receipts of the clients' trades and were only issued to the clients after they had settled the outstanding amounts, and (ii) there was no restriction on access to trading documents, it appears that she was not alert to the risks that such practices posed and therefore did not implement proper procedures and controls to change such practices.

The Internal Control Review

2.25. The results of the Internal Control Review confirmed that, subject to further slight improvements that can be made to its systems, Sun On Tat has remedied its internal control deficiencies:

2.25.1. The Reviewer did not find any instances of Sun On Tat using cash clients' securities to settle late/failed settlement of sell transactions of other clients during a review period exceeding one month in 2011.

2.25.2. The Reviewer finds that Sun On Tat's procedures to ensure that (i) cash client securities and margin client securities received via CCASS or from clients and held for clients are respectively segregated in appropriate designated accounts with CCASS on a timely basis, and (ii) Sun On Tat's own securities are not commingled with client securities are operating effectively.

2.25.3. Although Sun On Tat has yet to implement the Reviewer's recommendation that there should be separation of front-line and back office staff in the office setting, the Reviewer is of the view that there is segregation of duties between Sun On Tat's front-line operations and back office operations from a functional perspective, despite the lack of physical separation.

- 2.25.4. The Reviewer is satisfied that Sun On Tat's control procedures are operating effectively to ensure that monthly and daily statements of account and contract notes are properly prepared and provided to clients in accordance with the Contract Notes Rules.
- 2.25.5. While the Reviewer recommends that all important and confidential documents (including daily contract notes, dealing tickets, etc) be stored in locked cabinets, the Reviewer is satisfied that there are controls to ensure that the trading documents generated from the settlement database are provided to clients without unauthorized interception.
- 2.25.6. The Reviewer considers that there is room for Sun On Tat to enhance its policies and procedures but nonetheless considers that the management supervision exercised by Sun On Tat's management was adequate and effective for ensuring that Sun On Tat is in compliance with the applicable rules and regulations in all aspects of its operations.

3. Breaches and reasons

- 3.1. In addition to the specific requirements set out in paragraphs 2.7, 2.8, and 2.13-2.16 above, Sun On Tat, as a licensed corporation, has a duty:
- 3.1.1. under General Principle 2 of the Code of Conduct², to exercise due skill, care and diligence and to act in the best interests of its clients;
 - 3.1.2. under General Principle 3 of the Code of Conduct, to have and employ effectively the resources and procedures which are needed for the proper performance of its business activities;
 - 3.1.3. under General Principle 7, to comply with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interest of clients and the integrity of the market;
 - 3.1.4. under General Principle 8 of the Code of Conduct, to ensure that client assets are promptly and properly accounted for and adequately safeguarded;
 - 3.1.5. under paragraph 4.3 of the Code of Conduct, to have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its clients and other licensed or registered persons from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions;

² Code of Conduct for Persons Licensed by or Registered with the SFC

- 3.1.6. under paragraph 11.1(a) of the Code of Conduct, in handling of client transactions and assets, to act to ensure that client assets are accounted for properly and promptly;
 - 3.1.7. paragraph 12.1 of the Code of Conduct, to comply with, and implement and maintain measures appropriate to ensure compliance with the law, rules, regulations and codes administer or issued by the SFC; and
 - 3.1.8. under paragraph 13c of the Appendix of the Internal Control Guidelines, to securely store firm and client assets.
- 3.2. In this case, in addition to the breaches set out in paragraphs 2.7, 2.8, and 2.13-2.16 above, Sun On Tat has also breached:
- 3.2.1. General Principles 2 and 8 and paragraph 11.1(a) of the Code of Conduct in using one client's securities to settle another client's transaction and in failing to put in place an adequate system to ensure that securities it received in its CCASS Clearing Account (A/C 01) were properly segregated;
 - 3.2.2. General Principles 2 and 8 and paragraph 11.1(a) of the Code of Conduct in failing to put in place an adequate system to ensure that securities it received in its CCASS Clearing Account (A/C 01) were properly segregated;
 - 3.2.3. General Principle 2 of the Code of Conduct and Paragraph 13c of the Internal Control Guidelines in failing to have adequate control over access to trading documents;
 - 3.2.4. General Principles 2 and 3 and paragraph 4.3 of the Code of Conduct in not having adequate management supervision and in failing to implement proper internal control procedures to protect its operations and its clients; and
 - 3.2.5. General Principle 7 and paragraph 12.1 of the Code of Conduct in failing to comply with, and implement and maintain measures appropriate to ensuring compliance with, the law, rules, regulations and cods administered or issued by the SFC.
- 3.3. Kwong, as a licensed representative and responsible officer of Sun On Tat, has a duty:
- 3.3.1. under General Principle 2 of the Code of Conduct, to exercise due skill, care and diligence and to act in the best interests of its clients;
 - 3.3.2. under General Principle 3 of the Code of Conduct, to have and employ effectively the resources and procedures which are needed for the proper performance of Sun On Tat's business activities;
 - 3.3.3. under General Principle 7 and paragraph 12.1 of the Code of Conduct, to comply with, and implement and maintain

measures appropriate to ensure compliance with the law, rules, regulations and codes administered or issued by the SFC;

3.3.4. under General Principle 9 of the Code of Conduct, to bear primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by Sun On Tat; and

3.3.5. under paragraph 14.1 of the Code of Conduct, to properly manage the risks associated with Sun On Tat's business.

3.4. In the circumstances, we are of the view that Kwong has breached:

3.4.1. General Principles 2, 3 and 9 of the Code of Conduct by failing to ensure the maintenance of appropriate standards of conduct and adherence to proper procedures by Sun On Tat;

3.4.2. General Principle 7 and Paragraph 12.1 of the Code of Conduct by failing to comply with, and implement and maintain measures appropriate to ensuring compliance with the law, rules, regulations and codes administered or issued by the SFC; and

3.4.3. Paragraph 14.1 of the Code of Conduct by failing to properly manage the risks associated with Sun On Tat's business.

3.5. We consider Sun On Tat and Kwong's failures to be serious. In particular:

3.5.1. We view most grimly Sun On Tat's practice of allowing one client's securities to be used to settle another client's transactions, as safe custody of client assets is a fundamental obligation of licensed corporations. Any transgression of this obligation, even if the relevant clients are made whole again, cannot be tolerated.

3.5.2. Inadequate management supervision, particularly coupled with deficiencies in other areas of Sun On Tat's internal controls, made Sun On Tat's operations susceptible to abuse and malpractice to the prejudice of the firm's and clients' interests without the transgressions being noticed by management.

4. Conclusion

4.1. Having regard to the seriousness of Sun On Tat and Kwong's breaches, and the risks that such breaches posed to Sun On Tat's clients' interests, the SFC has decided to take the disciplinary action against Sun On Tat and Kwong as described in paragraph 1.1 above. In taking such action, the SFC has taken into account all relevant considerations, including that the Internal Control Review confirmed that Sun On Tat has largely remedied the inadequacies in its internal control system.